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Leveraged Loans and Systemic Risk (Last of a Series)

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If nothing else, the history of leveraged lending since the credit crisis shows both regulators and regulated entities have worked to shift loans off bank balance sheets.

The object of Leveraged Lending Guidance, in turn, was not to eliminate credit risk, but limit the most aggressive bank lending practices – for example, leverage over six times ebitda. That would, in turn, help minimize risk to depositors.

The Great Recession only accelerated what has been twenty-plus years of disintermediation from banks to "shadow" banks. In 1997, as our *Chart of the Week* shows, banks held two-thirds of all institutional term loans. Today it's less than 9%.

Even as Dodd-Frank was being ironed out, came worries that future loan problems would be far less transparent to regulators. If non-bank investors took on more risk, subsequent credit problems would be outside agencies' purview.

Another key lesson of the crisis for asset managers was to rely less on short-term warehouse lines. CLOs, mutual funds, finance companies, hedge funds, insurance companies, and other institutional investors, are now generally supported by long-term, diversified financing sources.

Of course, mitigating the risk of systemic infection doesn't mean there aren't weaknesses in the loans themselves.

In a well-reasoned note from PIMCO's Beth MacLean last month [link], she identifies four concerns: First, more lower-rated (i.e. single-B or worse) assets today than in the last cycle. Next, a greater share of senior debt-only structures without the cushion that bonds or other junior capital provides. Also, cov-lite is more widespread. Finally, more issuer-friendly terms related to debt incurrence, asset sales, and dividends.

These issues taken together suggest that loans will suffer higher default rates and lower recoveries. But, as Ms. MacLean reports, projecting 30% defaults (vs. 20% coming out of 2009) and 50% recoveries (vs. 65%), result in estimated losses of $172.5 billion. The four FAANG stocks have lost almost four times that since October.

Think of the enhancements to CLO structures and warehouse financings. Since 2007 these vehicles, the biggest buyers of leveraged loans, have seen improved subordination to the most credit-worthy tranches. Leverage, once provided by hedge funds and total-return swap (TRS) lines, has been cut in half. And CLOs are no longer mark-to-market, so falling loan prices are less likely to trigger forced asset selling.

Such features put leveraged loans in a much different risk category from sub-prime mortgages, despite frequent attempts to link them.

While credit markets might temporarily stall in a downturn, experience has shown that will be short-lived. Recessions also have the salutary effect of shaking off less capable, shallow-pocketed managers, leaving behind a healthier financing industry.